

Directors' report on operations

Shareholders,

In 2008, the **Pirelli & C. Group** suffered as a result of the international financial crisis which signaled a sharp downturn of the global economy that had serious repercussions on the automotive and real estate sectors. In order to confront this scenario, during the year the group launched a far-reaching restructuring process which was accelerated in the fourth quarter in the light of the prospects for 2009 which again made it necessary to implement measures that could ensure efficiency and competitiveness.

The negative performance of the financial markets caused the value of financial assets to decline. This resulted in an impairment on the stakes held in listed companies, in reference to the investments held in Telecom Italia S.p.A., RCS Mediagroup S.p.A. and Avanex Corporation of Euros 263 million.

On the whole, the Group ended the year with a slight fall in revenues, on a like-for-like basis, (taking into account the assets classified to discontinued operations and the sales made in 2007 for the deconsolidation of DGAG and the foreign exchange effect). The Group also reported an operating profit, even after restructuring expenses of Euro 144.2 million, although it was considerably lower than in 2007. The bottom line is a loss of Euros 412.5 million which includes the impairment loss on real estate assets for Euros 136 million and the impairment loss on financial assets for Euros 263 million.

The net financial position at December 31, 2008 is a net debt position of Euros 1,028 million with equity of Euros 2,374 million. It should be noted that financial investments were made during the year for the purchase of the 38.9 percent stake in Pirelli Tyre (Euros 835 million) and minority stakes in the companies in Turkey (Euros 43 million). These investments are part of the strategy to boost the tyre business.

With regard to its core businesses, **Pirelli Tyre** closed 2008 with slightly higher revenues on a like-for-like basis, despite the very negative economic situation. Margins were affected by raw material price increases which, in 2008, brought higher costs of about Euros 200 million, and also by the crisis in the car market which hit the Original Equipment channel.

To combat this scenario, the company launched restructuring measures which were accelerated in the last quarter in the presence of a further deterioration of the market. The aim of these measures is to strengthen the competitiveness of the industrial operations in Europe and reduce the costs of central structures and thus produce an impact on the income statement of Euros 100 million.

The operating profit before restructuring expenses is Euros 250.7 million, with a reduction of 30 percent compared to Euros 358.1 million in 2007. If restructuring expenses are also taken into account, the operating profit is equal to Euros 150.7 million.

In **Real Estate**, the market suffered from a year of serious international crisis. Falling prices, fewer transactions and the credit crunch penalized all companies in the sector. To contrast the changed scenario, the Pirelli & C. Real Estate group (henceforth referred to as 'Pirelli RE') implemented a program to reduce costs and reorganize its operations. The program, which focuses on the two macro-geographical areas of Italy and Germany/Poland, aims to relaunch activities and capitalize on the quality of the assets in the real estate portfolio.

In this scenario, real estate sales are down 48 percent overall from last year, the operating result including earnings (losses) from investments, before restructuring expenses and impairment losses/reversals, is an operating loss of approximately Euros 59.7 million against an operating profit of Euros 83.6 million in 2007 (net of the temporary contribution by DGAG of Euros 21.4 million). The operating loss was then impacted by impairment losses of Euros 135.8 million and restructuring expenses of Euros 44.2 million in connection with the rationalization of the structures and the organization.

With regard to other businesses, **Pirelli Broadband Solutions**, the company that is active in broadband access systems, continued to grow, with an increase in revenues and growth in profit results. As far as **Environment and Sustainable Mobility** activities are concerned, investments continued during the year in Romania for the production of particulate filters, where operations began at the end of the year.

The **Parent, Pirelli & C. S.p.A.**, closed the year with a loss of Euros 189.5 million, having been directly or indirectly affected by the impairment losses recognized on listed companies for Euros 263 million.